

***United States Court of Appeals  
for the Second Circuit***



**APPELLEE'S BRIEF**



74-1680

UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

MANAGEMENT DYNAMICS, INC., EDWIN BARRETT,  
CLYDE GOFF, EPHRAIM HOFFMAN, PETER R. WATSON,  
GLOBAL SECURITIES, INC., ALLEN LANGENAUER,  
DAVID LANGENAUER, BERNARD OSCHERS, LEE  
SCHNEIDER, JOSEPH CIRELLO, FAIRFIELD SECURITIES,  
INC., THOMAS F. BRENNAN, III

Defendants, and

WILLIAM N. LEVY, A. J. CARNO, INC.,  
ANTHONY NADINO, MAYFLOWER SECURITIES, INC.,

Defendants-Appellants.

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

MANAGEMENT DYNAMICS, INC., et al.,

Defendants, and

SAMUEL D. HODGE,

Defendant-Appellant

Appeals from the United States District Court  
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

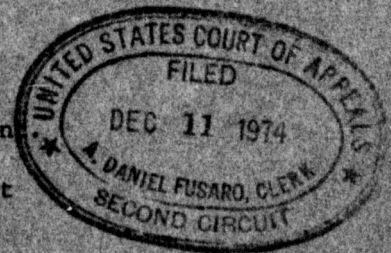
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UNITED STATES COURT OF APPEALS  
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Plaintiff-Appellee,

v.

MANAGEMENT DYNAMICS, INC., EDWIN BARRETT,  
CLYDE GOFF, EPHRAIM HOFFMAN, PETER R. WATSON,  
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DAVID LANGENAUER, BERNARD OSCHERS, LEE  
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WILLIAM N. LEVY, A. J. CARNO, INC.,  
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Appeals from the United States District Court  
for the Southern District of New York

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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COUNTERSTATEMENT OF ISSUES  
PRESENTED FOR REVIEW

1. Whether the district court could find on a motion for preliminary injunction that it was likely that at the trial on the merits the Securities and Exchange Commission would prove that



antifraud provisions of the federal securities laws were violated by

- a. two securities broker-dealer firms that, together with a third firm, (1) entered increasingly higher bid quotations in the "pink sheets" for the shares of a stock, thereby creating the appearance of an active market for the stock, without disclosing that their bids were being entered essentially on behalf of a fourth broker-dealer that was repurchasing virtually all of the stock that was being tendered in response to the bid quotations, (2) the quotations were at prices based in no way upon the financial condition or prospects of the issuer of the stock, and (3) the broker-dealers were aware of the complete absence of demand for the stock on the part of public investors;
- b. the chief trader of one of the broker-dealers, who was responsible for the submission of his firm's quotations and who admitted that the quotations were based solely on "market activity";
- c. an experienced securities lawyer who prepared or edited literature disseminated by a recently reactivated company that he controlled, which spoke in glowing terms about the company's proposed development of three parcels

of real estate but failed to disclose the substantial obstacles that stood in the way of that development.

2. Whether the district court could find on a motion for preliminary injunction that it was likely at the trial on the merits the Commission would prove that the registration provisions of the securities laws were violated by

- a. an experienced securities lawyer who caused a corporation that he controlled to issue 960,000 shares of stock that were never registered with the Commission and which he delivered, at a time when the market price for the company's stock was rapidly rising, to an individual who offered 100,000 shares of the stock for sale in the over-the-counter market, and
- b. the securities broker-dealers whose bidding and buying activities created the active, rising market for the stock which in turn created both the incentive and the opportunity for the attempted sale of the 100,000 shares.

3. Whether a defendant was properly enjoined for failing to comply with an order of the district court directing him to appear as a witness at an evidentiary hearing conducted by the district court to resolve factual disputes in connection with a motion of the Commission for a preliminary injunction.

COUNTERSTATEMENT OF THE CASE

Preliminary Statement

These are appeals from two orders entered on April 15 and 18, 1974 (132a-135a), <sup>1/</sup> by the United States District Court for the Southern District of New York (Robert L. Carter, J.) in an action brought by the Securities and Exchange Commission against 18 defendants, alleging they had violated the registration <sup>2/</sup> and antifraud provisions of the federal securities laws <sup>3/</sup> with respect to the securities of Management Dynamics, Inc. One order preliminarily enjoined six of the defendants. These include the four appellants in No. 74-1680: William N. Levy, A. J. Carno, Inc., Anthony Nadino, and Mayflower Securities, Inc. The other order permanently enjoined by default, for failing to appear at the hearing after being ordered by the court to be present, Samuel D. Hodge. He is the appellant in No. 74-2148. The case has been disposed of with respect to the remaining defendants except for Joseph Cirello

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1/ "\_\_\_a" refers to pages of the appendix filed by the parties, with an identification of the witness where the reference is to pages of the transcript of the evidentiary hearing; "\_\_\_s" refers to pages of the supplemental appendix containing exhibits. In addition, "Carno Br. \_\_\_" refers to pages of the brief filed by Mr. Carno and Mr. Nadino; "Mayflower Br. \_\_\_" refers to pages of Mayflower's brief; "Levy Br. \_\_\_" refers to pages of Mr. Levy's brief; and "Hodge Br. \_\_\_" refers to pages of Mr. Hodge's brief.

2/ Sections 5(a) and (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and (c).

3/ Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5.

and Thomas F. Brennan, III, two non-appealing defendants pre-  
liminarily enjoined by the order involved in No. 74-1680.<sup>4/</sup>

The court's findings of fact and conclusions of law, which appear in its opinion of April 10, 1974, are not yet reported.

The Commission's Complaint

The facts alleged in the Commission's complaint are to the effect that the appellants participated in a scheme by which public investors were defrauded through (1) the reactivation of defendant Management Dynamics, Inc., a dormant, publicly-held corporation with virtually no assets; (2) the infusion into Management Dynamics of assets that were falsely represented to the public as likely to generate high earnings; (3) the touting of Management Dynamics stock by a securities broker-dealer, defendant Global Securities, Inc., by such false representations; and (4) Global's enlistment of three other broker-dealers, appellants Carno and Mayflower and defendant Fairfield Securities, Inc., to insert bids for Management Dynamics stock in the National Quotations Bureau "pink sheets,"<sup>5/</sup> thereby

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<sup>4/</sup> Each of the 11 other defendants in this action have been enjoined permanently from violating the registration and antifraud provisions referred to in nn. 2, 3, supra. Defendants Management Dynamics, Inc., Edwin Barrett, Clyde Goff, Ephraim Hoffman, Global Securities, Inc., Allen Langenauer, David Langenauer, Bernard Oschers, Lee Schneider and Fairfield Securities, Inc., consented to the entry of permanent injunctions; and defendant Peter R. Watson was permanently enjoined by default by reason of his failure to file an answer.

<sup>5/</sup> The pink sheets are a compilation published by the National Daily Quotations Bureau of the bid and ask quotations for securities traded in the over-the-counter market. Merritt Vickers, Inc. v. Securities and Exchange Commission, 353 F. 2d 293 (C.A. 2, 1965).

creating a false appearance of interest in the stock in the over-the-counter market. As a result of this scheme the market price of Management Dynamics stock rose from 62.5¢ to \$6 per share in only four months.

It is further alleged that when the market price for its stock was rapidly climbing, Management Dynamics issued 960,000 shares of its common stock, which were delivered to defendant Peter Watson, who attempted unsuccessfully to sell at least 100,000 of these shares, although no registration statement had been filed with the Commission as required by the Securities Act. Before the Commission suspended trading in Management Dynamics stock on December 8, 1972, however, Global had already sold about 40,000 shares of the company's stock to the public, almost all of which had been obtained from defendants-appellants Carno and Mayflower and from defendant Fairfield.

#### The Reactivation of Management Dynamics

As of June 1972, Management Dynamics had no business activities, its assets consisted solely of a one-acre tract of land in Canada, and its debts amounted to about \$50,000 (Barrett 151a-154a; 1s). The company was controlled by appellant William Levy, an experienced securities lawyer, who had been an officer and director of Management Dynamics since its founding in 1969 (Barrett 148a; Levy 239a-240a, 248a, 251a, 304a; Hoffman 199a; 1s). <sup>6/</sup> Mr. Levy was the sole corporate

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<sup>6/</sup> Mr. Levy was a 1966 graduate of the University of Pennsylvania Law School (Levy 239a). He had prepared approximately nine registration statements and two offering circulars that were filed with the Commission (Levy 239a-247a), and he had represented securities broker-dealers (Levy 242a).

officer, the others having "just quit and left" (Levy 259a). At that time, there were approximately 1,300,000 shares of Management Dynamics stock outstanding (Barrett 156a), of which Mr. Levy owned about 50,000 shares (Levy 251a, 304a).

Management Dynamics did have one potentially useful attribute-- the fact that its common stock, held by several hundred persons, was sporadically traded in the over-the-counter securities market (Barrett 150a). These shares, which had never been registered with the Securities and Exchange Commission (61s), had been issued by the company in about 100 separate transactions, mostly for services, in 1969, 1970 and 1971 (37s).

Mr. Levy initiated the resurrection of Management Dynamics in June 1972 by entering into an arrangement with defendant Edwin Barrett, a real estate developer, whereby the company would acquire certain of Mr. Barrett's assets, which were valued at about \$100,000, in exchange for a controlling block of the company's common stock (Barrett 138a-156a). Mr. Barrett evidently was willing to accept stock for his assets because of his "desire to have ... [his] business operated through the vehicle of a public company" (Barrett 142a). Mr. Barrett testified that "taking my company public [by way of a registered public offering] . . . would have been an expensive and undoable thing," since "building and real estate companies are not exactly the kind of companies in which people readily invest their money, especially small ones, like mine" (Barrett 143a, 146a). These assets to be acquired by the company from Mr. Barrett were 9.14 acres

of land in Red Hill, Pennsylvania; an apartment site in Philadelphia, Pennsylvania; an option to acquire land in Bass River Township, New Jersey; and an option to acquire land in Harleysville, Pennsylvania (5s).

The Barrett deal required the approval of Management Dynamics shareholders, since it was necessary to increase the number of authorized shares in order for the company to issue a controlling block of stock to Mr. Barrett (Barrett 151a, 156a; 1s). With this in mind, on June 14, 1972, Mr. Levy appointed two individuals as directors, and immediately convened a board meeting at which the company issued 450,000 shares of its unregistered stock to defendants Ephraim Hoffman and Clyde Goff in exchange for \$50,000 in cash (1s). The next day, the new directors resigned and were replaced as directors by Messrs. Hoffman and Goff, who also became officers of the company (id.). On July 10, 1972, this new board voted to acquire Mr. Barrett's assets in exchange for 2,700,000 shares of stock, subject to shareholder approval (id.).

On August 15, 1972, Mr. Levy wrote a letter to Management Dynamics' shareholders seeking approval of the Barrett deal (1s). As we discuss more fully below, pp. 17-24, this letter created the materially misleading impression that the company's acquisition of Mr. Barrett's assets would assure a bright future for the company in the field of real estate development. Thereafter, at a meeting of Management Dynamics' shareholders held September 6, 1972, the authorized shares of the company's common stock were increased from

2,000,000 to 8,000,000 (Barrett 151a-157a; 1s); Mr. Barrett received 2,700,000 of these newly-authorized shares in exchange for his assets, and became president of the company (Barrett 154a-157a; 2s, 11s). A press release was subsequently issued on October 13, 1972 (12s), and another shareholder letter was sent on October 25, 1972 (10s-11s), both of which greatly reinforced the misleading impression created by the earlier letter that the assets acquired from Mr. Barrett were sure to generate substantial income for the company. See discussion, infra, pp. 17-21.

The Creation of a False Appearance of Activity  
in the Market for Management Dynamics' Stock.

As of August 1972 there was virtually no activity in the market for Management Dynamics stock (Dreyer 206a-207a, 209a-210a; 13s, 15s, 60s). During June and July 1972, the only quotations that had appeared in the "pink sheets" for Management Dynamics stock were bids of  $\frac{3}{8}$  of a dollar per share (Dreyer 207a). Sometime in the fall of 1972, however, Mr. Levy supplied copies of the two shareholder letters and the press release to defendant David Langenauer, vice president of defendant Global Securities, Inc. (D. Langenauer 224a). Mr. Langenauer caused copies of these misleading documents to be distributed to Global's customers (D. Langenauer 225a), many of whom were thereby

induced to order Management Dynamics stock (19s-29s).<sup>7/</sup>

Although Global presumably could have obtained shares to fill those orders by inserting its own bid quotations for Management Dynamics stock in the pink sheets, the firm chose instead to enter into arrangements with three other over-the-counter securities firms, pursuant to which those firms would acquire Management Dynamics' stock by placing quotations in the pink sheets and then reselling the stock to Global at higher prices. This arrangement created the appearance of greater interest and activity in the stock than if Global had entered its own quotations (13s, 15s, 19s, 30s, 46s).

Those three firms -- appellants Carno and Mayflower and defendant Fairfield -- thereafter engaged in continuous active bidding for the stock until December 8, 1972, when trading was suspended, even though the traders who were directly responsible for the quotations knew virtually nothing about the company and had no demand for the stock from their own public customers (Brennan 305a-313a; Cirello 315a-321a; Nadino 323a-328a; 30s, 42s, 46s, 59s).

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<sup>7/</sup> Global's willingness to aid Mr. Levy by touting the Management Dynamics stock was evidently connected with the fact that during this period Mr. Levy had located a financial angel for Global, which had apparently been in poor financial condition (D. Langenauer 226a-234a). The angel was appellant Samuel Hodge, who in October 1972 purchased a one-third interest in Global for \$50,000 and loaned the firm another \$25,000 (D. Langenauer 226a-228a). Global's first transaction in Management Dynamics stock was a purchase on October 8, 1972, of 3,000 shares from Hodge Record Mfg. Co., which Mr. Hodge controlled (D. Langenauer 229a; 19s).

During the period of September 15 to December 7, when Mayflower, Carno and Fairfield were inserting quotations in the pink sheets, Mayflower purchased about 9400 Management Dynamics shares, of which about 7200 shares -- or about 75% -- were sold to Global (30s); Carno bought about 13,270 shares, of which about 7900 -- or about 60% -- went to Global (46s); and Fairfield bought about 4,700 shares, of which about 4,450 or about 95% were sold to Global (42s); Brennan 308a).

Between September 14 and December 8, 1972, Global sold about 3,600 shares of Management Dynamics stock to 34 customers at prices between \$3 and \$4; 4,400 shares to 40 customers at prices in the \$4 to \$5 range; 5,500 shares to 19 customers at prices in the \$5 to \$6 range; and 10,500 shares of Management Dynamics stock to 26 different customers at a price of \$6 or more (19s). Global had obtained the bulk of this stock from appellants Carno and Mayflower and defendant Fairfield (19s).

There was, in fact, nothing new about the financial condition or operations of Management Dynamics that would objectively justify a rise in the price of its stock to \$6 per share. At that price, the market value of the company's outstanding stock was \$24,000,000 -- about 150 times the company's book value (5s). One of the company's own directors, defendant Hoffman, conceded that a bid of \$6 was "crazy" (Hoffman 220a-221a), and when defendant Barrett was asked

whether a book value of \$24,000,000 was appropriate, he replied:

"No, of course not" (Barrett 189a).

The Issuance by Management Dynamics of 960,000 Unregistered Shares in Order to Take Advantage of the Rising Market in the Company's Shares.

In late October and early November 1972, when the price of Management Dynamics' stock was rapidly climbing, Mr. Levy caused the company to issue 960,000 unregistered shares, which he delivered to defendant Peter R. Watson with the understanding that Mr. Watson would attempt to find buyers for the stock (Barrett 157a-159a; Levy 262a-269a). The certificates for these 960,000 shares were in 5,000 share denominations and bore no restrictive legend to alert a prospective buyer that they were being offered by the issuer and might not be readily transferable (Barrett 160a-168a; Levy 260a-263a).<sup>8/</sup>

Following his receipt of the shares, Mr. Watson, who lived in Florida, "traveled around many places" (Levy 289a), including Texas and California (Levy 290a). During this period, Mr. Nadino, the trader at Carno, received a telephone call from an individual in

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<sup>8/</sup> Compare Section 5 of the Securities Act requiring registration, with Section 4(1), which exempts from the registration requirements all persons who are not issuers, underwriters or dealers.

As a securities lawyer, Mr. Levy was aware that it was a better practice for a corporation issuing unregistered stock to place a notation or "legend" on the certificates restricting the manner in which the securities could be resold (Levy 260a-264a, 269a; Barrett 159a-162a).

California who was offering 100,000 Management Dynamics' shares for sale (Nadino 329a-330a, 334a). This individual, who did not state his last name (Nadino 330a), gave Mr. Nadino the numbers of the certificates for the offered shares (Nadino 334a), which revealed that the certificates were among those Mr. Levy had turned over to Mr. Watson (Nadino 334a-335a).

The Opinion of the District Court

In its opinion of April 10, 1974, which followed a two-day evidentiary hearing at which 12 witnesses testified, the court below concluded that

"[t]he illegal conduct of defendants and the Commission's right to injunctive relief have been clearly and conclusively established." (131a).

The court enjoined appellants Levy, Carno, Nadino and Mayflower, and defendants Cirello and Brennan, from violating the registration requirements of Sections 5(a) and 5(c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and 77e(c), the antifraud provisions of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5, in connection with the securities of Management Dynamics or any other security (131a).

The court found the August and October shareholder letters and the press release fraudulent (1) because they omitted material facts regarding the conditional nature of the two options that Management

Dynamics acquired from Mr. Barrett in September 1972 and a third option acquired by the company shortly thereafter, while extolling their value, and (2) because they did not reveal Mr. Barrett's indispensability to the company (127a). The court held that Mr. "Levy's responsibility for those documents has been established," and observed that "his familiarity with the securities field makes clear that his action cannot be described as inadvertent" (128a).

The court held that the antifraud provisions had also been violated by Carno and Mayflower and Messrs. Nadino, Cirello and Brennan in trading and quoting Management Dynamics shares. The court found these quotations to have been "at prices not related to the activities of the company," and that they caused "artificially high prices" to be maintained (128a). The court concluded:

"What was done here constituted fictitious quotations and manipulation of . . . [Management Dynamics] shares" (128a).

Finally, the court found that Mr. Levy had violated the registration provisions by delivering the 960,000 unlegended shares to Mr. Watson, thus enabling him to offer those shares for purchase to others (129a), which in fact he did. The broker-dealer defendants were held to have participated in this violation by having helped to create the active trading market for the company's shares, which in turn created the incentive and opportunity for Mr. Watson to attempt to sell the shares in his possession (129a).

ARGUMENT

- I. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN PRELIMINARILY ENJOINING APPELLANT'S LEVY, CARNO, NADINO AND MAYFLOWER, PENDING A TRIAL ON THE MERITS, FROM VIOLATING REGISTRATION AND ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS

Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), provides that the Commission may bring an action in an appropriate United States District Court to enjoin acts or practices which constitute or will constitute violations of the Act, and that "upon a proper showing a permanent or temporary injunction . . . shall be granted . . . ." Section 21(e) of the Securities Exchange Act, 15 U.S.C. 78u(e), is similar. This Court has repeatedly held that the Commission has made a proper showing sufficient to permit injunctive relief where there is a reasonable expectation of future violations by the defendants; it has also held that such an expectation of future violations may be inferred from past violations. Securities and Exchange Commission v. Shapiro, CCH Fed. Sec. L. Rep. ¶94,494 [1973-1974 Decisions] (1974); Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1100 (1972); Securities and Exchange Commission v. Culpepper, 270 F. 2d 241, 249-250 (1959).<sup>9/</sup> Moreover,

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<sup>9/</sup> Accord, Securities and Exchange Commission v. First American Bank & Trust Co., 481 F. 2d 673, 682 (C.A. 8, 1973); Securities and Exchange Commission v. Keller Corp., 323 F. 2d 397, 402 (C.A. 7, 1963). Cf. United States v. W. T. Grant Co., 345 U.S. 629, 633 (1953).

where, as here, the Commission is merely seeking a preliminary injunction pending a final determination on the merits, this Court has held that it is "only necessary for the court to find that the . . . agency had presented a strong prima facie case [that past violations had occurred] to justify the discretionary issuance of the interlocutory restraint." Securities and Exchange Commission v. Boren, 283 F. 2d 312 (1960). Accord, Securities and Exchange Commission v. First American Bank & Trust Co., 481 F. 2d 673, 682 (C.A. 8, 1973); Securities and Exchange Commission v. Bennett & Co., 207 F. Supp. 919, 923 (D. N.J., 1962).<sup>10/</sup> Thus, one who seeks reversal of a preliminary injunction granted at the Commission's request must sustain a heavy burden.<sup>11/</sup>

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<sup>10/</sup> As this Court stated in Hamilton Watch Co. v. Benrus Watch Co., 206 F. 2d 738, 740 (1953), which was a private suit for a preliminary injunction:

"To justify a temporary injunction it is not necessary that a plaintiff's right to a final decision, after a trial, be absolutely certain, wholly without doubt; if the other elements are present (i.e., the balance of hardships tips decidedly toward plaintiff) it will ordinarily be enough that the plaintiff has raised questions going to the merits so serious, substantial, difficult and doubtful as to make them a fair ground for litigation and thus for more deliberate investigation" (footnote omitted).

Appellants Carno and Nadino acknowledge that "[a]t this stage of the litigation, it is not necessary to decide whether the S.E.C. has proved violations . . . ." (Carno Br. 7). Similarly, Appellant Levy speaks of the requirement that a party seeking a preliminary injunction must show "[p]robable success on the merits . . . ." (Levy Br. 52).

<sup>11/</sup> Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F. 2d at 1100; Securities and Exchange Commission v. Culpepper, supra, 270 F. 2d at 249; cf., United States v. W. T. Grant Co., supra, 345 U.S. at 633.

A. Mr. Levy Violated the Antifraud Provisions of the Federal Securities Laws.

As we noted above, pp. 9-10, before Global sold thousands of shares of Management Dynamics stock to its customers at prices of up to \$6 per share, it had sent its customers copies of a letter that Management Dynamics had sent to its shareholders on August 15, 1972 (1s), a Management Dynamics press release dated October 13, 1972 (10s), and a letter sent to the company's shareholders on October 25, 1972 (10s). The record shows that Mr. Levy had prepared the August letter (Levy 252a-253a) and had reviewed and approved the press release and October letter (Barrett 194a-195a) after they had been prepared by Mr. Barrett (Barrett 198a). And Mr. Levy supplied those documents to Global for dissemination to its customers (D. Langenauer 224a). The district court found each of these documents to be materially false and misleading in violation of the antifraud provisions of the securities laws (127a).

The letters and press release conveyed the impression that the company had a bright future in real estate development, by exuding optimism about the company's growth potential -- in particular, about its ambitious plans to develop three tracts of land it had options to purchase. This impression was highly misleading since there were substantial, undisclosed obstacles that stood in the way of the successful development of those properties.

The shareholder letter of August 15, 1972, announced the company's agreement to issue 2,700,000 shares of common stock to Mr. Barrett in exchange for two tracts of land in Pennsylvania and options on properties located in Bass River Township, New Jersey and Harleysville, Pennsylvania (1s). By this letter, Mr. Levy conveyed the impression that the acquisition would lead the company into the promised land of high earnings. He told the shareholders -- who included a number of brokerage houses (Barrett 175a) --

"not only are Mr. Barrett's assets of solid value to the company; but, in addition, Mr. Barrett has demonstrated the requisite leadership capability and good business judgment to lead the company to its anticipated potential of strong and solid growth in both revenues and earnings" (1s).

In the context of this language, by stating that "there can be no assurance that the acquisition of Mr. Barrett's assets will lead to the development of a highly successful company,"<sup>12/</sup> however, Mr. Levy may have reinforced the impression that there was at least a strong likelihood that the acquisition would have such an effect. Mr. Levy strengthened his vision of growth and future success by describing in ambitious terms the "Proposed Business of the Company." Thus Mr. Levy wrote of

"the acquisition of developed and undeveloped real estate; the planning, engineering, zoning and site development concerned with such real estate; and the design, planning and construction of dwelling units, commercial building and other structures which the company may hold for investment, lease or sell" (2s).

These activities were described, moreover, as what the "primary operations" of the company would "include," thus implying that there was even more in store for the future (2s).

The letter did not reveal, however, that the option on the Bass River property was not even exercisable unless the Environmental Protection Agency should have approved the construction of a sewage facility and all other necessary governmental approvals, such as zoning, should have been obtained (Barrett 172a-173a). Nor were investors told that the Harleysville property could not be developed unless and until the zoning on that land should have been changed from "agricultural" to "high density residential" (Barrett 173a).

The letter to shareholders of October 25, 1972, spoke in glowing terms about the company's plans to develop the parcels covered by the Bass River and Harleysville options, but, as in the case of the earlier letter, omitted to disclose the conditions that had to be met before the Bass River option could be exercised and the fact that before the company could even hope to generate income from the Harleysville property a drastic change in zoning would be required (10s). Thus, with respect to the Bass River property the letter spoke of the "large tract of land" covered by the option, on which the company was planning to engage in "the massive and complex undertaking" of "develop[ing] a new community under Title VII of the Federal Housing and Urban Development Act of 1970" (11s). The

letter added that as "further developments" occurred on this project shareholders would be kept informed (11s), conveying the false impression that the company had already made some significant progress toward its goal of building the "new community."

With respect to the Harleysville option, the October 25 letter spoke of the company's intention to build a "planned residential development consisting of townhouses, garden apartments, and single family dwellings . . . some 250 units in all" (11s). The letter did state that development was "contingent upon the successful achievement of zoning changes" (11s), but did not indicate the drastic nature of the changes required.

In the news release of October 13, 1972, which accompanied the October 25 letter, the company announced its purchase of an option to buy 700 acres of land in Burlington County, N.J. The release spoke of the company's "plans to construct a retirement community [on this land] containing approximately 2,000 to 2,800 dwelling units together with commercial and recreational facilities" (12s). As the release noted, the option was subject both to the passage of a local ordinance permitting construction and to obtaining permission from the State of New Jersey for the building of a sewage treatment facility. The release strongly implied, however, that neither of these conditions would present a problem. It quoted Mr. Barrett as saying that "there appears to be no obstacle in the way of passage of the local ordinance . . . [and] preliminary studies for an acceptable sewage treatment plant are already underway" (12s). Contrary to the impression created by these statements, however, there was no assurance

that the conditions would be met (Barrett 183a-184a).

The press release was further misleading in giving the impression that the company would have no difficulty in obtaining the financing necessary to develop the Burlington County land. The release stated that the purchase price of the land "would be in excess of \$1 million" and that "[m]ortgage financing for the entire project would be in excess of \$25 million." Nowhere was it disclosed in either the October 15 letter or the press release that the company had no income, that Mr. Barrett, the main employee, was receiving no salary, that the company had only two other employees and that Mr. Barrett was paying the company's expenses out of his own funds (Barrett 151a-153a, 184a-188a).

Finally, the court noted (123a) that neither the shareholder letters nor the press release disclosed the material fact that Mr. Barrett was indispensable to the functioning of the company (Barrett 184a-188a).

In view of the various respects in which the shareholder letters and press release inflated the company's purported prospects, while at the same time concealing information that was essential to an intelligent appraisal of those prospects, the district court reasonably found that those communications were materially false and misleading in violation of the antifraud provisions of the Securities Act and the Securities Exchange Act. See, e.g., Securities and Exchange Commission v. North American Research and Development Corp., 424 F. 2d 63, 75-77 (C.A. 2, 1970); Securities and Exchange Commission v. Great American Industries, Inc., 407 F. 2d 453, 456-458 (C.A. 2, 1968) (en banc),

certiorari denied, 395 U.S. 920 (1969). These findings of fact must affirmed since they are, at the very least, not clearly erroneous. See, United States v. United States Gypsum Co., 333 U.S. 364, 394-395 (1948); Lassiter v. Fleming, 473 F. 2d 1374 (C.A. 2, 1973); Ideal Toy Corp. v. Sayco Doll Corp., 302 F. 2d 623 (C.A. 2, 1962).

The statements in the communications regarding the options were unquestionably "material" within the meaning of Rule 10b-5 since the company's ability to develop the land covered by the options was a factor "which in reasonable and objective contemplation might affect the value of the corporation's stock . . . ." List v. Fashion Park, 340 F. 2d 457, 462 (C.A. 2), certiorari denied, 382 U.S. 811 (1965).<sup>13/</sup> Mr. Levy attempts to minimize the importance of the options by referring to the fact that the Bass and Harleysville options were assigned a valuation that was a small fraction of the company's assets (Levy Br. 39). The materiality of the options does not derive, however, from the dollar value attributed to them on the company's balance sheet but from the plain implication of the letters and release that these properties were the key to the company's growth. Accepting the importance attributed to these properties by the defendants, therefore, disclosure of the conditional nature of the options was needed to give a true picture of the company's future. On the other hand, if Mr. Levy were correct that these properties should be considered insignificant, the letter and release would then

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<sup>13/</sup> Accord, Kohler v. Kohler Co., 319 F. 2d 634, 642 (C.A. 7, 1963).

have to be considered misleading for having given them such undue prominence.

Mr. Levy also claims (Br. 41) that, contrary to the district court's finding (127a), Mr. Barrett's indispensability to the company was adequately disclosed. He relies, however, only on the statement in the August letter that the company's board considered Mr. Barrett's assets to be of solid value and considered Mr. Barrett to have good business judgment and leadership capability (1s). This expression of regard for Barrett and his property hardly serves to convey the fact that Mr. Barrett was the only person connected with the company who had any experience with the type of real estate development work projected for the future.<sup>14/</sup>

Finally, Mr. Levy argues that he neither knew nor had any reason to know, of any deficiencies in the press release and October letter and that he was entitled to rely upon Mr. Barrett, the experienced real estate developer, to see to it that the communications accurately described the company's real estate plans and activities. But Mr. Levy needed no experience in the real estate business to recognize these as the selling documents they were, and as the reviewer of those documents (Levy 257a), as the company's

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<sup>14/</sup> Mr. Levy's argument (Br. 41-42) that the company could not properly have disclosed Barrett's indispensability because "it could easily have been interpreted as an ultimatum to the shareholders to approve Barrett's acquisition" of company stock in exchange for assets does not explain why the company failed to make the disclosure in the October communications, when that acquisition was no longer an issue.

chief counsel (Levy Br. 34) and as an experienced securities lawyer,<sup>15/</sup> Mr. Levy had a duty to ascertain from Mr. Barrett what types of obstacles the company was likely to encounter. Mr. Levy's failure to make such inquiry -- if that be the case -- would require the conclusion that at the very least he did not exercise due diligence in ascertaining the accuracy of the communications. He must bear responsibility for their inaccuracies. Moreover, the district court's finding that Mr. Levy's failure to include qualifying material in the communications was not "inadvertent" (128a) is plainly supported by the evidence as a whole.<sup>16/</sup> In any event, as an officer of the company who participated in the preparation and dissemination of materially false and misleading information affecting the purchase and sale of securities, the district court was justified in entering a preliminary injunction against him. Securities and Exchange Commission v. North American Research & Development Corp., supra, at 78-80.

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<sup>15/</sup> See n.6, supra, p. 7.

<sup>16/</sup> Appellants Carno and Nadino seem to believe that they were found by the district court to have violated the antifraud provisions in connection with the dissemination of the August and October communications (Carno Br. 28-29). That is not true. The district court carefully distinguished between Mr. "Levy's responsibility for these documents" (128a) and the violation of the antifraud provisions by Appellants Carno and Nadino in connection with the submission of fictitious quotations for Management Dynamics stock.

B. Appellants Carno, Mayflower and Nadino Violated the Antifraud Provisions.

The court below also found that the conduct of Carno, Mayflower and Nadino, among others, "in trading and quoting . . . [Management Dynamics'] shares at prices not related to the activities of the company is also violative of the antifraud provisions of the Securities Act . . . . What was done here constituted fictitious quotations and manipulation of . . . [Management Dynamics'] shares" (128a).

The record fully supports this conclusion. It demonstrates that no information concerning the company was available to these defendants except the self-serving promotional press release and shareholder letters (Cirello 309a, 315a; Nadino 322a-323a) that the sophisticated defendants must have recognized for what they were; that inquiries these defendants had sent to the company had not been answered (Cirello 316a; Nadino 323a); that in the absence of any demand by their public customers (30s, 42s, 46s) these defendants repeatedly inserted quotations in the pink sheets based solely upon Global's willingness to pay a premium for shares acquired (Brennan 306a; Cirello 319a); and that these defendants quoted Management Dynamics' securities at increasingly higher prices until the Commission suspended trading in its stock on December 8, 1972.

Appellant Mayflower began inserting quotations in the pink sheets shortly after Allen Langenauer, Global's president, called Mayflower's trader, defendant Joseph Cirello, telling him that Global was a "potential buyer in the stock" (Cirello 314a). Mr.

Cirello admitted that he caused Mayflower to purchase the company's stock "[o]nly when [he] . . . was given a verbal open order [by Global]" (Cirello 319a). Mr. Cirello continued to insert quotations in the pink sheets even after a letter he wrote to the company requesting information had been returned "address unknown" (Cirello 316a); he admitted that his quotations were based solely upon "[t]he bids that were around in the street . . .," and in no way reflected the company's financial condition (Cirello 318a-319a).

Appellant Carno began inserting quotations in the pink sheets for Management Dynamics stock on a regular basis on September 14, 1972 (15s). Although the firm had engaged in sporadic trading of the stock in the early part of 1972 (57s-58s), the firm had not inserted any quotations during June, July or August of 1972 (Dreyer 206a-207a; 15s). Mr. Nadino, the trader at Carno who caused these new quotations to be submitted, based his quotations solely upon "market activity" (Nadino 327a). Mr. Nadino admitted that the company had never responded to a letter he sent to it requesting information (Nadino 323a; 59s).<sup>17/</sup>

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<sup>17/</sup> Defendant Fairfield began entering quotations for the stock after Global's president, defendant Allen Langenauer, entered into an arrangement with Fairfield's chief trader, defendant Thomas F. Brennan, III, whereby Global would purchase every share of Management Dynamics stock that Fairfield could buy at 1/8 of a dollar over Fairfield's cost (Brennan 305a-309a). According to Mr. Brennan: "If I bought it [Management Dynamics' stock] I was going to sell it to Global . . . . I had no knowledge of, you know, no real interest in the stock. To me it was just a number to trade" (Brennan 308a). Fairfield Securities first inserted a quotation on November 9, 1972, at \$5-1/2 bid, \$6-1/2 ask, and continued to insert similar quotations for the next four weeks (15s).

The following schedule shows the quotations inserted in the pink sheets by appellants Carno and Mayflower prior to the suspension of trading in Management Dynamics stock (15s):

		<u>Carno</u>		<u>Mayflower</u>	
		Bid	Ask	Bid	Ask
September	14	2-1/4	2-3/4		
	19	2-1/2	3		
	26	2-1/2	3		
	28	2-1/2	3	2-1/2	3-1/4
October	3			3	3-1/4
	5			3-1/4	4
	10	4-1/4	4-3/4	4-1/4	4-3/4
	12			5	5-1/2
	17			4-3/4	5-1/4
	19	5	5-1/2	4-3/4	5-1/4
	24			4-5/8	5-1/8
	26			4-3/4	5-1/4
	31			5-1/2	6-1/2
November	2	5-3/4	6-1/2	5-7/8	6-3/8
	6	5-1/2	6	5-1/2	6-1/2
	9	5-3/4	6-1/2	5-3/4	6-1/2
	14	6	6-3/4	6	6-3/4
	16		6-3/4	6-1/4	6-3/4
	21			6	6-3/4
	24	5-1/2	6-1/4	6	6-3/4
	28			6	6-3/4
	30			6	6-3/4
December	1			6	6-3/4
	4			6	6-3/4
	5			6	6-3/4
	6	6	6-1/2	6	6-3/4
	7	5-3/4	6-1/2	5-3/4	6-1/2
	8			5-3/4	6-1/2

These facts evidence a "course of business" or "a device, scheme or artifice" that operated as a fraud upon all members of the public who traded in Management Dynamics stock based upon the false appearance of value and the false appearance of broad public interest in the securities of Management Dynamics that were the result of these activities.

The "state of the market" -- i.e., the amount of activity in the security, the "size" or "depth" of the market, the volume of trading, the price at which trades are being consummated -- is highly important to investors who are concerned about the liquidity of their investment and the opportunities for resale.<sup>18/</sup> Moreover, "there is a direct correlation between the number of broker-dealers inserting two-way quotations in a particular security and the volume in that security," Franklin National Bank v. L. B. Meadows & Co., Inc., 318 F. Supp. 1339, 1347 (E.D. N.Y., 1970).<sup>19/</sup> Thus, "the more frequently a security is quoted, or the greater the number of dealers quoting the security, the broader and more active the appearance of the market for that security." Securities and Exchange Commission v. Resch-Cassin & Co., Inc., 362 F. Supp. 964, 967 (S.D. N.Y., 1973) (emphasis added.)<sup>20/</sup>

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<sup>18/</sup> See, e.g., Over-The-Counter Market Quotations, 52 Cornell L. Q. 262, 263-264 (1967); Note, Manipulation of the Stock Markets Under the Securities Laws, 99 U. Pa. L. Rev. 651, 652 (1951); Note, Regulation of Stock Market Manipulation, 56 Yale L. J. 509, 512-516 (1947); H. R. Rep. No. 1383, 73rd Cong., 2d Sess. (1934), p. 11; Berle, Liability for Stock Market Manipulation, 31 Col. L. Rev. 264, 265-271 (1931).

<sup>19/</sup> The court was quoting from Burns, Over-The-Counter Market Quotations, supra, 52 Cornell L. Q. at 268-269.


<sup>20/</sup> Accord, Masland, Fernon & Anderson, 9 S.E.C. 338, 346 (1941); F. S. Johns & Co., Inc., Securities Exchange Act Release No. 7972 (October 10, 1966), affirmed, Dlugash v. Securities and Exchange Commission, 373 F. 2d 107 (C.A. 2, 1967); Theodore A. Landau, 40 S.E.C. 1119, 1123-1124 (1962). See also, Franklin National Bank v. L. B. Meadows & Co., Inc., supra, 318 F. Supp. at 1347; Securities and Exchange Commission, Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess., Part 2, p. 605 (1963); Note, Regulation of Stock Market Manipulation, supra, at 513.

Members of the public are entitled to rely upon established market prices -- including bid and asked quotations tendered by registered broker-dealers -- as fairly derived from the impact of essentially random buying and selling decisions upon the market place. Unusual or concentrated activities often tend artificially to inflate or depress the market price. While an unusual degree of market activity may sometimes be legitimate -- as where open market purchases are being made by a person seeking to acquire control of a company -- a demand stimulated by the activities of one or very few buyers is often a highly suspicious circumstance.

As a result of the trading activities of Carno, Mayflower and Fairfield, public investors and securities professionals were entitled to assume either that a substantial number of public investors had sought to obtain the securities of Management Dynamics or that these three firms were purchasing the stock for their own accounts based upon their evaluation of its investment merit.

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21/ As the Commission pointed out in Securities Exchange Act Release No. 7381 (August 6, 1964), which announced the adoption of Rule 15c2-7, 17 CFR 240.15c2-7, "the failure to differentiate in any way quotations entered for correspondents and quotations representing multiple expressions of the same market, prevents persons using the sheets from determining the actual depth and activity of the market for a particular security . . . ." 2 CCH Fed. Sec. L. Rep. ¶77,111 at p. 82,033 (emphasis added). The release went on to point out that the publisher of the pink sheets had recently improved its publication, so that the listings in the sheets could show whether quotations submitted by a firm were actually being submitted on behalf of another firm.



The fact that neither alternative was true demonstrates the deceptive nature of these defendants' course of conduct.

The deceptiveness of the Carno and Mayflower activities is compounded by the fact that their quotations, as the firms necessarily knew, were constantly increasing in price, thus reinforcing the false impression of an active market for Management Dynamics stock. The courts and the Commission have recognized on numerous occasions that the insertion of increasingly higher bids for stock in the sheets creates an appearance of activity in the stock.<sup>22/</sup>

It is significant also that the insertion of the quotations by Carno and Mayflower served to further Global's fraudulent sale of Management Dynamics securities to its customers. The false appearance of substantial market interest served to complement Global's dissemination to its customers of the materially false Management Dynamics press release and shareholder letters. In touting Management Dynamics stock to its customers, Global could point not only to the company's assertedly bright prospects but also to the apparent fact that the market for the company's stock was active and rising.

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E.g., Securities and Exchange Commission v. Resch-Cassin & Co., Inc., supra, 362 F.Supp. at 976; Otis & Co., Inc. v. Securities and Exchange Commission, 106 F. 2d 579, 582-583 (C.A. 6, 1939); F. S. Johns & Co., Inc., supra; Dlugash v. Securities and Exchange Commission, supra; Sidney Tager, Securities Exchange Act Release No. 7368 (1964), affirmed, Tager v. Securities and Exchange Commission, 344 F. 2d 5 (C.A. 2, 1964); Advance Research Assoc., Inc., 41 S.E.C. 579, 603-607 (1963); Gob Shops of America, Inc., 39 S.E.C. 92, 101 (1959); Halsey, Stuart & Co., Inc., 30 S.E.C. 106, 125 (1949); M.S. Wein & Co., 24 S.E.C. 4, 13-14 (1946); Masland Fernon & Anderson, supra, 9 S.E.C. at 346; Barrett & Co., Inc., 9 S.E.C. 319, 328 (1951).

In Dlugash v. Securities and Exchange Commission, 373 F. 2d 107 (C.A. 2, 1967), this Court affirmed an administrative decision of the Commission in a proceeding based upon a course of conduct similar to the case at bar.<sup>23/</sup> The principal respondent in that proceeding had

"entered and caused the entry of quotations for Diversified stock in the sheets . . . at continually increasing prices for the purpose of creating the appearance of an independent active market for such stock, when in fact the market was dominated and controlled by the respondents and there was no reasonable basis for any increase in the quoted prices." <sup>24/</sup>

In affirming the remedial action taken by the Commission against a broker-dealer that had cooperated in this activity this Court observed, 373 F. 2d at 109:

"[W]ith regard to manipulation, the . . . [broker-dealer petitioners] knew that there was no demand for Diversified stock. Moreover, rapidly rising prices in the absence of any demand are well-known symptoms of such unlawful market operations. See Gob Shops of America, Inc., 39 S.E.C. 92, 101 (1959). These attendant conditions were more than sufficient to put the petitioners on notice that something was wrong. Under such circumstances they were under a duty to investigate . . . ."

In the instant case, while Carno, through Mr. Nadino, and Mayflower were contributing to the rapid rise of the price of the stock (the increase from August 1972 to November 1972 was about 1,000 percent), both knew that there was no demand from the firm's public customers for Management Dynamics stock. They should have realized -- if in fact they

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<sup>23/</sup> F.S. Johns & Co., Inc., Securities Exchange Act Release No. 7972 (October 10, 1966).

<sup>24/</sup> Id. at p. 8.

did not -- that there was a strong possibility that their quotations and purchases were aiding a manipulation by Global, as they in fact were. By failing to pursue inquiries either about Management Dynamics, which would have revealed that a bid of \$6 for its stock was "crazy," (see page 11, supra) or about the reasons for Global's extraordinary purchase program, which might have revealed that Global was touting the stock by means of false literature, they shared responsibility for the success of Global's manipulation,<sup>25/</sup> and were properly enjoined by the court below pending a hearing on the merits of the Commission prayer for permanent relief.

Although a corporation can act only through its agents, Carno attempts to escape responsibility for its unlawful activities by arguing (Br. 30-33) that Mr. Nadino, its vice president in charge of trading, was "responsible for all of Carno's trading in Management Dynamics' stock," and that Carno would be liable, if at all, only under the "controlling persons" provisions of Section 20(a) of the Securities Exchange Act, 15 U.S.C. 78u(a). That Section renders "controlling persons" jointly and severally liable for the violations of persons controlled, but does not impose liability where "the controlling person

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See D. H. Blair & Co., Securities Exchange Act Release No. 8888 (May 21, 1970), where the Commission said:

"At the least, when trading is conducted by the numbers and no basis exists for determining whether price movements have any relation to the investment value of the security, a particularly close supervision must be maintained with a view to detecting any signs of possible manipulation or other irregularity." Id. at p. 11.

acted in good faith and did not directly or indirectly induce the act or acts constituting the violation . . . ."

The violations committed by Mr. Nadino were necessarily violations by Carno as well. Mr. Nadino was Carno's agent, and the quotations he submitted for Management Dynamics' stock were in the name and on behalf of the firm. Moreover, according to Carno's president, another principal of the firm reviewed all trades (Berkson 353a); thus he, as well as Mr. Nadino, must have been aware of the steadily increasing price Mr. Nadino was paying for Management Dynamics' stock and that the bulk of stock acquired was being resold to Global.<sup>26/</sup> Under elementary agency law "[a] principal, although personally innocent, is liable . . ." for the wrongful acts of its agent as actually authorized,<sup>27/</sup> apparently or ostensibly authorized, or within his agency powers.

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<sup>26/</sup> When the district court considers whether to grant permanent relief, we hope to demonstrate significance in the facts that Robert Berkson, Carno's president, had met with Mr. Levy four or five times during the fall of 1972 (Berkson 351a), and that one of Mr. Berkson's personal clients was appellant Samuel D. Hodge (Berkson 353a), who had supplied large amounts of capital to Global. On at least two occasions Mr. Berkson accepted orders from Mr. Hodge to sell shares of Management Dynamics' stock, which Mr. Berkson passed along to Mr. Nadino for execution. Perhaps Mr. Hodge, who failed to attend the hearing (see page 46, *infra*), can be examined at the trial on the permanent injunction. The foregoing and other facts that might develop at the trial may show that one or more of the broker-dealers involved were aware of the unregistered offering or that there were more facts showing they should have been aware.

<sup>27/</sup> Restatement (Second), Agency, §§257 and Comment b, 261 and Comment a (1957).

This principle was recognized by this Court in Gross v. Securities and Exchange Commission, 418 F. 2d 103, 107 (C.A. 2, 1969), when it affirmed remedial action taken by the Commission against one of three principals in a broker-dealer firm. This Court upheld the Commission's conclusion that he had aided and abetted activities of the firm which were found to be in violation of the federal securities laws solely on the basis of his "participation in the management of the firm and his knowledge of the course of conduct in which his firm was engaging . . . ."

In view of Carno's liability under basic agency principles, the "controlling persons" provisions of Section 20(a) are essentially irrelevant. They were designed to impose liability in situations where the liability of a controlling person might not otherwise exist because of technical legal barriers; for example, Section 20(a) will permit the corporate veil to be pierced in order to reach controlling stockholders. It was intended to enlarge, not restrict, the scope of vicarious liability otherwise arising under the securities acts. <sup>28/</sup>

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The original Senate version of the Securities Act of 1933 contained a number of provisions designed "to aid in preventing directors from evading the liabilities incident to signing the registration statement . . ." S. Rep. No. 47, 73rd Cong., 1st Sess., 5. This draft of the Act dealt with the use of a "dummy" signer of a registration statement and made the fraudulent use of a "dummy" unlawful. S. 875, 73rd Cong., 1st Sess. (April 17, 1933), 77 Cong. Rec. 2979. The House version, which contained registration and antifraud provisions very much like those eventually adopted, contained no sections expressly dealing either with "dummies" or with controlling persons. H.R. 5480, 73rd Cong., 1st Sess. (May 4, 1933). In conference these "'dummy provisions' which were calculated to place liability upon a person who acted through another,

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Hence the exceptions set forth in that subsection are applicably only when it is necessary to invoke these expanded premises of liability. Conversely, these exceptions do not have to be reached here because Carno's liability may be and should be determined directly under the antifraud provisions themselves.

There is no suggestion in the legislative history of the Securities Exchange Act that Congress contemplated that Section 20(a) could or would be invoked to shield broker-dealers from responsibility for the acts of their employees within the scope of their employment. To accept Carno's view would mean that the federal securities laws would provide less protection for persons defrauded by employees of broker-dealer firms than state law does. This anomalous interpretation would unjustifiably offend the policy that the federal securities laws constitute remedial legislation, to be construed "not technically and restrictively, but flexibly to effectuate . . . [their] remedial purposes."

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28/ (Footnote continued)

irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by one party over the other . . . [were] welded into one and incorporated as a new section in the substitute." H. Conf. Rep. No. 152, 73rd Cong., 1st Sess. 27. The "new section" is what is now the controlling-persons provision of Section 15 of the Securities Act. Thus, that section was the result of congressional concern with the special problem presented by the use of "dummies," and was not designed to govern the usual employment situation.

The legislative history of Section 20(a) of the Securities Exchange Act indicates that the same Congress that had passed the Securities Act continued to understand the controlling-persons provisions as applying only in these special circumstances. See, Testimony of Thomas C. Corcoran, one of the authors of the Securities Exchange Act, and Richard Whitney, then president of the New York Stock Exchange, Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72nd Cong.) and S. Res. 56 and 97 (73rd Cong.), 73rd Cong., 1st Sess. 6561, 6639.

Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).<sup>29/</sup> Accordingly, in Johns Hopkins University v Hutton, 422 F. 2d 1124, 1130 (C.A. 4, 1970), the court of appeals, in affirming the district court's finding that the defendant broker-dealer was liable under agency principles for the fraudulent acts of its employees, stated that the controlling-person provision of the Securities Act "was not intended to insulate a brokerage house from the misdeeds of its employees."

This Court's decision in Lanza v. Drexel & Co., 479 F. 2d 1277, 1299 (C.A. 2, 1973) (en banc), which is cited by appellants Carno and Nadino (Br. 32), does not stand for any different principle. That case involved the question of liability of corporate directors who had not participated in the unlawful acts of other corporate officials. This Court recognized that they would be liable, if at all,

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<sup>29/</sup> Carno and Nadino also claim that the injunction against violations of the antifraud sections was based in part upon an erroneous finding that they violated Commission Rule 15c2-11, 17 CFR 240.15c2-11 (Carno Br. 29-30, and also at 7, 10, 20). That rule provides that it shall be a fraudulent, manipulative and deceptive device within the meaning of Section 15(c)(2) of the Exchange Act, 15 U.S.C. 78o(c)(2), for a broker-dealer to submit quotations for securities unless specified conditions are met, one of which is that the broker-dealer have certain information in his records concerning the issuer of the securities. See Rule 15c2-11(a)(4), 17 CFR 240.15c2-11(a)(4). Whether or not they violated that rule, there was no finding of violation. The court merely observed that Carno and Mayflower appeared not to have complied with the rule because they lacked certain information about Management Dynamics when they submitted quotations for its stock (127a-128a).

only under Section 20(a) and held that they might establish a good faith defense under Section 20(a) with respect to these unlawful actions. That holding cast no doubt upon the propriety of finding the corporation itself liable for the acts of its agents, which is all that is involved here. To the extent that the United States District Court for the Southern District of New York viewed the Lanza decision differently in Securities and Exchange Commission v. Lums Inc., 365 F. Supp. 1046, 1061-1064 (1973); Gordon v. Burr, 366 F. Supp. 156, 168-170 (1973), and in Barth v. Rizzo [Current] CCH Fed. Sec. L. Rep. ¶94,741 (1974), we submit that court was in error.

C. Appellants Levy, Carno, Nadino and Mayflower Violated Registration Provisions of the Securities Act.

Section 5(c) of the Securities Act provides generally that it is unlawful for any person to make use of any instrumentality of transportation or communication in interstate commerce "to offer to sell" any security unless a registration statement concerning that security has been filed with the Commission. The term "offer to sell" is defined to include "every attempt or offer to dispose of . . . a security . . . for value." Section 2(3), 15 U.S.C. 77b(c). The burden of establishing the availability of an exemption from the registration requirements is upon a person claiming the exemption, Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119, 126-127

(1953); <sup>30/</sup> and since the Securities Act is remedial legislation entitled to a broad construction, the terms of these exemptions must be narrowly construed. United States v. Custer Channel Wing Corp., 376 F. 2d 675, 678 (C.A. 4), certiorari denied, 389 U.S. 850 (1967). <sup>31/</sup>

Since the record demonstrates that Management Dynamics attempted to sell all or part of the large block of 960,000 shares delivered to defendant Peter Watson, (Barrett 159a; Levy 264a, 270a), the company violated Section 5(c) of the Securities Act. The fact of violation is further emphasized by the evidence showing that some of these shares were in fact later offered for sale to Carno by means of an interstate telephone call (Nadino 329a-330a, 334a).

Mr. Levy either caused or aided and abetted this violation; it was Mr. Levy who first suggested to the Management Dynamics board of directors that the 960,000 shares be issued (Barrett 159a); Mr. Levy was a member of the board which authorized the issuance of the shares to Mr. Watson (Barrett 165a); and it was Mr. Levy who delivered the certificates into Mr. Watson's hands (Barrett 162a-170a). In these circumstances, the district court was well within its discretion when

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<sup>30/</sup> Accord, Securities and Exchange Commission v. North American Research & Development Corp., supra, 424 F. 2d at 71-72; Securities and Exchange Commission v. Culpepper, supra, 270 F. 2d at 246 (C.A. 2, 1959); Gilligan, Will & Co. v. Securities and Exchange Commission, 267 F. 2d 461, 466 (C.A. 2, 1959); cf., Securities and Exchange Commission v. Chinese Consolidated Benevolent Association, 120 F. 2d 738, 741 (C.A. 2), certiorari denied, 314 U.S. 618 (1941).

<sup>31/</sup> Accord, Capital Funds, Inc. v. Securities and Exchange Commission, 348 F. 2d 582, 586 (C.A. 8, 1965).

it preliminarily enjoined Mr. Levy. See Securities and Exchange Commission v. Spectrum, Ltd., 489 F. 2d 535, 542 (C.A. 2, 1973).

The district court was also within the scope of its broad discretion when it preliminarily enjoined appellants Carno, Mayflower and Nadino from violations of the registration requirements. If the Commission had not timely suspended trading in the stock, Management Dynamics would likely have been successful in effecting sales of some or all of the shares entrusted to Mr. Watson; and this would have occurred primarily as a result of the favorable market climate that had been created through the unlawful course of conduct that appellants Carno, Mayflower and Nadino had pursued. It is essentially irrelevant whether or not these firms or Mr. Nadino were aware that the company had in fact issued stock for sale. It is not uncommon for persons in control of a corporation, or others, to manipulate stock in order to sell a substantial block at an artificially inflated market price. See, e.g., Securities and Exchange Commission v. North American Research & Development Corp., supra, 424 F. 2d at 70. Particularly in the circumstances we have discussed supra pp. 25-32, where the defendants plainly should have been sensitive to the fact that they were participating in manipulative activity, it is appropriate for the court to enter an injunction to assure that they will not be indifferent to their responsibilities in the future.

In Securities and Exchange Commission v. Spectrum, Ltd., supra, 489 F. 2d at 541, this Court expressly rejected the district court's view that "actual knowledge of the improper scheme plus an intent to

further that scheme" would have to be proved where aiding and abetting a registration violation is charged by the Commission. This standard was held to be

"... a sharp and unjustified departure from the negligence standard which we have repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief. SEC v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1096 (2d Cir., 1972); Hanly v. SEC, 415 F. 2d 589, 596 (2d Cir., 1969); SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 854-55 (2d Cir., 1968) (en banc), cert. denied, sub nom Kline v. SEC, 394 U.S. 976 (1969). Cf., Lanza v. Drexel, 479 F. 2d 1277, 1304 (2d Cir., 1973) (en banc)."

D. The District Court Did Not Abuse Its Discretion.

As we have demonstrated, there is ample evidence in the record before this Court to establish the existence of at least a prima facie case as to each of the violations found by the district court. Accordingly, the court below cannot be held to have abused its "broad discretion" in preliminarily enjoining appellants pending a trial on the merits. Cf., e.g., Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F. 2d at 1100.

Appellants Carno, Nadino and Levy argue that the Commission failed to show that the public would be injured by a denial of the preliminary injunction (Carno Br. 11; Levy Br. 54). But the cases appellants cite for this proposition are actions between private parties. As this Court recognized in Securities and Exchange Commission v.

Culpepper, supra, at 250, quoting from Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944), in an enforcement action brought by a federal agency "the standards of the public interest, not the requirements of private litigation measure the propriety and need for injunctive relief . . . ." <sup>32/</sup>

Thus, the courts have consistently ruled that the Commission is not required to make a specific showing of injury in order to obtain injunctive relief, whether preliminary, e.g., Securities and Exchange Commission v. First American Bank & Trust Co., supra, 481 F. 2d at 682, or permanent, e.g., Securities and Exchange Commission v. Culpepper, 270 F. 2d at 249.

The fact that the Commission has instituted administrative proceedings against Carno and Nadino based upon their activities with respect to Management Dynamics stock (Carno Br. 17) is no basis for vacating the injunction. The injunction has provided prompt and continuous protection to public investors against violations by the appellants. The Commission does not have authority through administrative <sup>33/</sup> proceedings to provide comparable relief.

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<sup>32/</sup> Cf., Mitchell v. Pidcock, 299 F. 2d 281, 287 (C.A. 5, 1962). See also, Virginia Ry. Co. v. System Federation No. 40, Etc., 300 U.S. 515, 552 (1927).

<sup>33/</sup> Pursuant to Section 15(b) of the Securities Exchange Act, 15 U.S.C. 78o(b), the Commission, after notice and an opportunity for hearing, may find it appropriate to go so far as to revoke the registration of Carno or Mayflower as brokers and dealers in securities or bar Mr. Nadino from further association with any broker or dealer. Pursuant to Section 15(b)(6), 15 U.S.C. 78o(b)(6), the Commission may, after notice and opportunity for hearing, suspend the registration of a broker-dealer pending its final decision in a revocation proceeding. But the Commission's temporary suspension like its final revocation would affect only the right of a firm to act as a broker-dealer, and in any event would, if violated, have to be

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Appellants are incorrect in stating that trading in Management Dynamics stock is presently suspended.<sup>34/</sup> But even if it were, the need for injunctive relief would still exist to assure that the defendants would take no unlawful action after the suspension should be lifted. Thus, in Securities and Exchange Commission v. Koenig, 469 F. 2d 198, 200 n.2 (C.A. 2, 1972), this Court noted that the suspension of trading in the securities involved continued at the very time it wrote an opinion affirming the entry of an injunction. Moreover, the court below considered appellants' misconduct to be of such a serious nature that it preliminarily

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33/ (Footnote continued)

enforced by court order. The Commission could not by administrative order forbid fraudulent acts or registration violations that a person might commit in some other capacity. Only an injunction issued by a court is available to assure the continued complete protection of the public.

34/ Pursuant to Section 15(c)(5) of the Securities Exchange Act, 15 U.S.C. 78o(c)(5), the Commission suspended trading for successive ten-day periods from December 8, 1972 until March 21, 1973, which was more than three months before the Commission filed its complaint. Securities Exchange Act of 1934, Release Nos. 9904 and 10,047 (Dec. 8, 1972 and March 19, 1972). The Commission's records show that this suspension has not since been reimposed.

Appellants Carno and Nadino give no record reference for their claim (Br. 11) that "[d]uring the evidentiary hearing held in the District Court, the S.E.C. conceded that all trading in the stock of Management Dynamics has been suspended since December 8, 1972," (emphasis in original). We can find no such concession.

Mr. Levy asserts (Br. 54) that trading was suspended on December 8, 1972 "and has not been reactivated to date." Reactivation of trading is not the Commission's responsibility. Having ended the trading suspension it cannot compel investors to trade when there is no interest in doing so.

enjoined them from violations of the securities laws not only with respect to the securities of Management Dynamics but with respect to any other securities (134a).

Appellants Carno and Nadino also argue that they face "substantial hardships" (Carno Br. 17) from the disqualifications that arise by operation of law from a preliminary injunction.<sup>35/</sup> a similar argument was made to this Court in Securities and Exchange Commission v. Culpepper, supra, but the fact that an injunction might be the basis for a proceeding to revoke the registration of a broker-dealer was held to be "not germane to . . . [this Court's] determination . . ." whether to affirm the entry of an injunction, 270 F. 2d at 252. This is a necessary result. It would be most anomalous if a court might be persuaded to forego injunctive relief and deny the public any protection whatever because the Congress or the Commission (in the exercise of rulemaking authority) has found that in certain situations

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<sup>35/</sup> Those disqualifications are that an enjoined person may not participate in an offering of securities made pursuant to Regulation A of the Securities Act (see Commission Rule 252(c)(4),(d)(2), 17 CFR 230.252(c)(4),(d)(2), nor serve as an employee, officer, director, member of the advisory board, advisor or depositor of an investment company (Section 9(a)(2) of the Investment Company Act of 1940, 15 U.S.C. 80a-9(a)(2)).

Specific procedures exist by which relief may be sought from those disqualifications; see Commission Rule 252(f), 17 CFR 230.252(f); Section 9(c) of the Investment Company Act, 15 U.S.C. 80a-9(c). Appellants have not availed themselves of these procedures.

where an injunction is warranted the public needs a greater measure of protection than the injunction alone would provide.

The fact that the preliminary injunction subjects appellants to the possibility of criminal contempt proceedings (Carno Br. 16) is plainly not a "hardship" necessitating relief from this Court; the deterrent effect of possible contempt proceedings is the very reason why an injunction is issued.

II. THE DISTRICT COURT PROPERLY ENJOINED APPELLANT HODGE BASED UPON HIS REFUSAL TO OBEY THE COURT'S ORDER DIRECTING HIM TO APPEAR AND TESTIFY AT THE EVIDENTIARY HEARING HELD BY THE DISTRICT COURT TO RESOLVE FACTUAL DISPUTES.

In its complaint in this action, the Commission charged that defendant-appellant Samuel Hodge had violated the antifraud and registration provisions of the securities laws along with the other defendants. It was alleged in particular that Mr. Hodge had supplied \$25,000 to defendant Global in order to enable the firm to support the market for Management Dynamics stock, 100,000 shares of which Mr. Hodge owned or controlled (12a). While Mr. Hodge admitted in his answer that he had supplied funds to Global and that he owned or controlled the Management Dynamics shares he denied complicity in any wrongdoing (105a-106a).

In the course of the action, the Commission attempted to depose Mr. Hodge but, because of objections he raised, the Commission was unable to take his deposition in advance of the evidentiary hearing held by the district court (200a). Thus, on October 19, 1973 --

the first day of the two-day evidentiary hearing -- Commission counsel requested the court to issue an order directing Mr. Hodge to appear to testify on October 23, 1973, which had been scheduled as the second hearing day (200a-201a). Through Mr. Hodge's counsel, who was present at the hearing, the court ordered Mr. Hodge to appear as requested, and advised counsel that Mr. Hodge would be held in default if he should fail to appear and testify (201a, 202a-205a).

When Mr. Hodge did not appear in court on October 23 (358a-359a), his attorney advised the court that he had informed Mr. Hodge of the Judge's order; he stated that Mr. Hodge had not appeared because he would have had to "obtain someone to care for his wife who is a complete invalid" (358a), and required more notice than he had been given. Neither then nor thereafter, however, did Mr. Hodge submit any sworn statement or doctor's certificate to show why his wife's condition had prevented his appearance or what attempts had been made to find someone to care for her on the day he had been directed to appear.

Although Mr. Hodge did not appear, evidence adduced at the hearing tended to show that Mr. Hodge, who owned about 100,000 shares of Management Dynamics stock, <sup>36/</sup> held a one-third ownership in Global -- the firm responsible for manipulating the price of Management Dynamics stock and defrauding its customers in the process (Langenauer 227a);

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36/ 105a-106a.

that he had advanced \$25,000 to Global during this period (228a); and that during the time Global was manipulating the stock, he had personally sold Management Dynamics stock into the market (229a-230a). Also before the court was an affidavit of Commission counsel asserting that Mr. Hodge's loan to Global enabled the firm to maintain a sufficient net capital position so that it could continue to purchase Management Dynamics' shares (30a). The affidavit further stated that Mr. Hodge's financial assistance made Global's buying program possible (36a).  
37/  
Mr. Hodge did not submit any opposing affidavit.

Some six months after the October 23, 1973 hearing, on April 5, 1974, the Commission gave notice to Mr. Hodge's counsel that the Commission would, on April 12, 1974, submit to the court a proposed order of default judgment against Mr. Hodge (Notice of Settlement). That order was signed by the court on April 12, 1974, and entered on April 18, 1974 (Order of Permanent Injunction).  
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In view of Mr. Hodge's failure to comply with a direct order of the court or to make an adequate showing why it had been impossible for him to have done so, the issuance of the injunction, which merely directed Mr. Hodge to obey the law,  
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was not an abuse of discretion.

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37/ In addition, the district court could have drawn an adverse inference from Mr. Hodge's failure to testify. N. Sims Organ & Co. v. Securities and Exchange Commission, 293 F. 2d 78 (C.A. 2, 1961), certiorari denied, 368 U.S. 968 (1962).

38/ In view of the notice given to his attorney, there is no merit to Mr. Hodge's contention that he lacked the three-day notice required by Rule 55(b) for the entry of a default judgment.

39/ See Mitchell v. Pidcock, 299 F. 2d 281, 289 (C.A. 5, 1962).

"It is well established that the district court has the authority to . . . enter default judgment . . . for failure to . . . comply with its orders . . . ." Flaska v. Little River Marine Construction Co., 389 F. 2d 885, 887 (C.A. 5, 1968).

In addition, a district court is authorized by Federal Rule 37(b)(2) to "render a judgment by default" against any party that "fails to obey an order to provide or permit discovery . . . ." The court's order of October 1973, was in the nature of a discovery order because, in effect, the court was directing that testimony that might have been obtained through Mr. Hodge's deposition -- which the Commission had been unable to take -- be given at the hearing on the preliminary injunction motion.

Mr. Hodge continues to assert that there was "good cause" for his failure to appear (Hodge Br. 5). If so, his proper remedy is not before this Court but to move in the district court pursuant to Rules 55(c) and 60(b), Federal Rules of Civil Procedure, for an order setting aside the injunction. <sup>40/</sup> As the record before the district court now stands, however, neither we nor the district court has any way of evaluating whether good cause existed for his failure to appear. If Mr. Hodge should make application to the district court and satisfactorily establish that he had been unable to appear at the time and place directed, the Commission may find no basis upon which to oppose his application.

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<sup>40/</sup> Federal Rule 55(c) provides that:

"For good cause shown the court may set aside an entry of default, and, if a judgment by default has been entered, may likewise set it aside in accordance with Rule 60(b)."

CONCLUSION

For the foregoing reasons, the judgments of the District Court should be affirmed.

Respectfully submitted

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Washington, D.C. 20549

September 1974

UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

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SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

MANAGEMENT DYNAMICS, INC., et al.,

Defendants, and

WILLIAM N. LEVY, MAYFLOWER SECURITIES, INC.,  
A. J. CARNO, INC., ANTHONY NADIN AND  
SAMUEL D. HODGE,

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No. 74-1680

CERTIFICATE OF SERVICE

I hereby certify that on November 13, 1974, I caused to be served by United States mail, postage prepaid, two copies of the printed brief of the Securities and Exchange Commission, appellee, to the following persons:

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